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IN THE

Supreme Court of the United States

October Term, 19[illegible]

No. [illegible]

James [illegible], Collector of Internal Revenue for the [illegible] District of New York,

Petitioner,

v.

John Thomas Smith,

Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT IN OPPOSITION.

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INDEX.

TABLE OF CASES CITED:

IN THE

Supreme Court of the United States

October Term, 1939.

No. 146.

JOSEPH T. HIGGINS, Collector of Internal Revenue for the Third District of New York,

Petitioner,

v.

JOHN THOMAS SMITH,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

Opinion Below.

The opinion of the Circuit Court of Appeals (R. 767-9) is reported in 102 Fed. (2d) 456.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered March 29, 1939 (R. 770). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether the taxpayer is entitled to deduct a loss arising from the sale of securities to a wholly owned corporation.

Statutes Involved.

The statutes involved are set forth in the Appendix, *infra*, page 15.

Statement.

The petition seeks review of a decision of the United States Circuit Court of Appeals for the Second Circuit reversing a judgment entered in accordance with the verdict of a jury returned in the Southern District of New York in an action brought for a tax refund.

On March 11, 1935 the Commissioner of Internal Revenue notified the taxpayer of the determination of a deficiency for the year 1932 of $35,189.44 and a fraud penalty of $17,594.72, making a total of $52,784.16. (R. 36-7, 416-419). The deficiency was based on the disallowance of losses arising from the sale of securities to Innisfail Corporation and to the taxpayer's wife. The taxpayer paid the alleged deficiency and filed a claim for refund. Upon the Commissioner's failure to rule on the claim within six months, the taxpayer instituted this action. The trial was by jury. Both sides moved for a directed verdict and both motions were denied (R. 375-6). The jury found for the taxpayer on the issue of the sale of stock to his wife and on the issue of fraud but found for the Collector on the issue of the sale to

Innisfail Corporation (R. 402-3). Judgment for the taxpayer was entered in the sum of $28,935.49 (R. 33-4).

The taxpayer appealed from that portion of the judgment which denied recovery for the loss asserted on the sale to Innisfail Corporation (R. 705-6). The Collector appealed from that portion of the judgment which granted recovery for the loss asserted on the sale to the taxpayer's wife but raised only the question of the proper cost basis of the stock sold (R. 753-4). The Collector did not appeal from that portion of the judgment which granted the taxpayer recovery of the fraud penalty.

The appeal and cross-appeal by the taxpayer and the Collector from the adverse portions of the judgment were heard by the Circuit Court of Appeals for the Second Circuit in January, 1939. The Court of Appeals reversed the judgment of the District Court on both issues, holding that the taxpayer was entitled to the loss on the sale to Innisfail Corporation and was not entitled to the cost basis he reported on the sale to his wife (R. 767-9). The Court of Appeals first ordered judgment to be entered in accordance with the opinion but, upon motion of the Collector, amended its opinion and ordered a new trial (R. 771-5).

In *Smith* v. *Higgins,* No. 147, this term, the taxpayer petitions for certiorari on the ground that the Court of Appeals erred in remanding the case for a new trial instead of ordering the entry of judgment. The taxpayer's petition also seeks review of the Court of Appeals ruling on cost basis. In the instant proceeding, the Collector petitions for certiorari on the

ground that the Court of Appeals erred in holding the taxpayer entitled to the loss arising from the sale of securities to Innisfail Corporation. The facts bearing on the Collector's petition may be summarized as follows:

Innisfail Corporation (hereinafter called "Innisfail") was organized under the laws of New Jersey in 1926 (R. 52, 427-35) and the taxpayer became the owner of all of its capital stock (R. 117). On December 29, 1932 the taxpayer sold and delivered a group of securities to Innisfail. Certificates for all of these securities were endorsed for transfer by the taxpayer to Innisfail (R. 54-61, 439-51). Requisite transfer stamps were attached in the amount of \$1732.72 (R. 343-5, 439-51). The stock was transferred on the books of each corporation from the taxpayer to Innisfail (R. 314-16, 318-19, 321-3, 640-3, 646-7) and new certificates were issued to Innisfail (R. 200). All the sales were made at prevailing market prices (R. 72-5) for a total of \$60,923.80 (R. 64-5). The securities had cost the taxpayer a total of \$234,002.31 (R. 237-40), which entailed a loss of \$174,811.23, including allowance for stamp taxes.

The taxpayer maintained a running account with Innisfail (R. 202-36, 614-16, 621-33). Immediately before the sale he owed Innisfail \$68,364.68 (R. 66, 614-15), principally as the result of cash dividends which he had received from certain Chrysler and Hudson stock, owned by Innisfail but registered in his name as nominee in accordance with common corporate practice (R. 118-22, 165, 202-13, 317, 614-15). As the purchase price of the securities which the taxpayer sold to Innisfail was \$60,923.80, the taxpayer gave Innisfail a check for \$7440.88 to balance the account (R. 66, 145-6, 177, 235-6, 452, 614-15). The

Board of Directors of Innisfail approved the acquisition of the securities by Innisfail from the taxpayer and the prices paid (R. 67).

Innisfail has received and kept all of the dividends on the securities purchased from the taxpayer (R. 200, 313, 315, 319-20, 322-3, 324-5). Innisfail has never reconveyed any of these securities to the taxpayer (R. 61). It was the taxpayer's unqualified intention to transfer title from himself to Innisfail and to retain no interest in the securities whatsoever (R. 61). It was at all times his purpose that Innisfail be an absolutely independent entity and that it stand on its own bottom (R. 128) as much as General Motors Corporation, of which the taxpayer was and is Vice-President and General Counsel (R. 76). At the time Innisfail made the purchase from the taxpayer, it had securities valued at $791,751.92 and cash of $17,115.03 (R. 150, 541).

In December, 1934, the taxpayer sold all of his Innisfail stock to his children (R. 68-70, 610-11) at a price equal to the amount that the stock had originally cost him and paid a gift tax of $35,325.30 on the difference between that price and the value of the stock at the time of the sale (R. 70-2, 612-13).

The taxpayer and Innisfail each kept a full set of books, consisting of a cash book, journal, ledger, check book and security record (R. 187). These books were periodically audited by Barrow, Wade, Guthrie & Co., certified public accountants (R. 173). They verified the taxpayer's indebtedness to Innisfail (R. 330) and the losses on the very sales by the taxpayer to Innisfail involved in this case (R. 334-6, 350, 667, 669-76). They found all the books and records of both the taxpayer and Innisfail to be in standard

form and made no reservations in their audit reports (R. 347-8).

Upon these undisputed facts,[1] the taxpayer based his motion for a directed verdict and upon them the Court of Appeals held that the Trial Court should have granted it.

Argument.

1. The Circuit Court of Appeals decision allowing the taxpayer a loss on the sale to Innisfail is not homage to empty formalism but adherence to a consistent pattern without which the law of taxation would be unintelligible. It is only one of the many consequences resulting from transactions between a corporation and its sole stockholder. Gain realized upon a sale by a corporation to its sole stockholder is taxable. *Burnet* v. *Commonwealth Improvement Company*, 287 U. S. 415, 419. "The fact that it had only one stockholder seems of no legal significance." Assets received on the complete liquidation of a corporation constitute taxable income to the sole stockholder. *France Co.* v. *Commissioner*, 88 Fed. (2d) 917 (C. C. A. 6); *Coxe* v. *Handy*, 24 Fed. Supp. 178 (D. Del.); *John K. Greenwood*, 1 B. T. A. 291. Losses sustained by a one-man corporation may not be reported in the individual income tax return of the sole stockholder. *Dalton* v. *Bowers*, 287 U. S. 404; *Menihan* v. *Commissioner*, 79 Fed. (2d) 304 (C. C. A. 2), cert. den. 296 U. S. 651. Periods during which a sole

[1] The Trial Judge charged the jury that "the evidence in this case is substantially undisputed, so that you are not confronted with the task of deciding what probably happened. What you will have to do is to take this evidence under careful consideration and decide what it proves" (R. 377).

stockholder and a corporation successively hold property may not be combined to make up the two years required for the creation of a capital asset. *Webber* v. *Knox*, 97 Fed. (2d) 921 (C. C. A. 8).

The record in this very case reveals a striking illustration of the reality of the corporate entity. Some years ago the taxpayer purchased 1,900 shares of Hudson stock for $158,000. In 1929 he sold the stock to Innisfail for $106,400. In 1932 Innisfail sold it in the open market for $12,000. The taxpayer, of course, did not and could not report Innisfail's heavy loss in his 1932 income tax return (R. 290-1). Thus it is that the entity of a wholly owned corporation has real significance and that it does not always redound to the sole stockholder's benefit. The economic tax result is to shift the seller's cost basis and to substitute what the purchaser pays. This is the same in all cases regardless of *descriptio personarum*.

As Mr. Justice Holmes observed with characteristic felicity in *Klein* v. *Board of Supervisors*, 282 U. S. 19, 24:

> "But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."

2. Four Courts of Appeals have been called upon to pass on the precise question involved in this petition. All have held the loss allowable. *Jones* v. *Helvering*, 71 Fed. (2d) 214 (App. D. C.), cert. den. 293 U. S. 583; *Commissioner* v. *Eldridge*, 79 Fed. (2d) 629 (C. C. A. 9); *Commissioner* v. *McCreery*,

83 Fed. (2d) 817 (C. C. A. 9); *Helvering* v. *Johnson*, 1939, C. C. H. Vol. 4, Par. 9542, decided June 1, 1939 (C. C. A. 8); *Foster* v. *Commissioner*, 96 Fed. (2d) 130 (C. C. A. 2), decided almost a year before the case at bar.[2]

Indeed, in *Gregory* v. *Helvering*, 293 U. S. 465, 469, the decision relied upon by the government in its petition, this Court gave explicit endorsement to *Jones* v. *Helvering*, *supra*, when it declared, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * *Jones* v. *Helvering*, 63 App. D. C. 204; 71 F. (2d) 214, 217."

Commissioner v. *Griffiths*, 103 Fed. (2d) 110 (C. C. A. 7), now pending on petition for certiorari, No. 49, this term, is not at war with the decision of the Court of Appeals in the case at bar. In the *Griffiths* case, the taxpayer, having been defrauded in the purchase of certain stock, arranged to settle his claim by reselling the stock to the vendor. Instead of proceeding to consummate the transaction, he organized a corporation and on the same day "sold" it the stock and the fraud claim on the installment basis. The following day the corporation "sold" the stock to the vendor. The taxpayer himself, however, signed the instrument of transfer to the vendor and personally executed and transferred to the vendor a release from the fraud claim. The taxpayer received the check for the proceeds of the sale and endorsed it

[2] The Board of Tax Appeals has consistently reached the same conclusion. *David Stewart*, 17 B. T. A. 604; *Corrado & Galiardi, Inc.*, 22 B. T. A. 847; *Edward Securities Corporation*, 30 B. T. A. 918; *Ralph Hochstetter*, 34 B. T. A. 791.

to the corporation. Plainly, this was a case of an assignment of income after realization and has nothing in common with the question involved in the case at bar. The taxpayer in the *Griffiths* case realized income and *then* conveyed it to the corporation. It was an arrangement "by which the fruits are attributed to a different tree from that on which they grew". *Lucas* v. *Earl*, 281 U. S. 111.

3. The government would deny the taxpayer the right to report the loss because of the alleged absence of a "business purpose" and asks the Court to apply the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465, *supra*. That case limits the scope of the reorganization provisions to transactions having a "business purpose", *i. e.*, those involving the reorganization of a business. Certainly this Court did not intend to introduce any such test for the determination of losses, especially since the Gregory opinion, as we have just seen, specifically approved *Jones* v. *Helvering, supra*. The Revenue Act itself sets up the standards by which losses are to be tested. Section 23 provides that there shall be allowed, as deductions, losses sustained during the taxable year "(1) if incurred in trade or business; or (2) if incurred in any transaction entered into for profit, though not connected with the trade or business".[3] The importation of the test of "business purpose" into the loss provision would not only flout the intent of Congress by abrogating subdivision (2), but would render the application of the provision a hopeless riddle. The government's construction would indeed deny a loss to a taxpayer who sold stock in the open market for the sole purpose of being able to report a loss in his income tax return.

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[3] See Appendix, page 15.

The *Gregory* case as well as *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, also cited in the government's petition, dealt with efforts to make transactions appear to be different from what they really were. In the *Gregory* case a corporation was created only to be destroyed. In the *Minnesota Tea* case money was "distributed" to stockholders, but they agreed to use it to pay the corporation's creditors. In both cases this Court held that the reality varied from the appearance. The taxpayer willingly applies this test to the case at bar. Was the sale to Innisfail real or sham? The uncontradicted evidence establishes that Innisfail actually acquired title to the securities, that it paid the taxpayer full consideration at prevailing market prices, that it received and kept the income from the securities and that it never reconveyed a single share to the taxpayer.

The government makes a further attack on the validity of the sale by arguing that the taxpayer, as sole stockholder of Innisfail, had the power to effect a reconveyance of the securities. In addition to the fact that the taxpayer did not effect such a reconveyance and that he put it out of his power to do so by disposing of all the stock of Innisfail, there is an equally devastating answer to the government's contention. *The taxpayer could have retaken the securities only in a taxable transaction*, for the reconveyance could be only by way of a dividend or upon liquidation of Innisfail. In either case, a substantial tax would have been incurred. Far from prejudicing the public revenue by any such manoeuver, the taxpayer would have incurred substantial additional tax thereby. Surely it will not be suggested that the taxpayer's "power" to *repurchase* the securities from Innisfail is of any significance for in that

event no sale of a listed security would ever be final for there is always "power" to repurchase such securities.

4. The government's petition anticipates but does not answer another insuperable objection to its plea. Section 24(a)(6) of the Revenue Act of 1934, c. 277, 48 Stat. 680, *infra*, page 15, was enacted for the very purpose of precluding losses like those involved in this case. In view of the frequent difficulty of sifting real from sham sales in such instances, Congress wisely eliminated such deductions altogether.[4] For honest taxpayers this presents no greater hardship than the economic waste of having to pay unnecessary commissions to brokers for finding a buyer and seller who find themselves and have agreed upon the market price on which both are willing to trade. The

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[4] The Report of the Committee on Ways and Means of the House of Representatives states at page 23, referring to Section 24(a)(6):

> "The bill adds to existing law a paragraph which will deny losses to be taken in the case of sales or exchanges of property between members of a family, or between a shareholder and a corporation in which such shareholder holds a majority of the voting stock. * * *
>
> "Experience shows that the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax. It is believed that the proposed change will operate to close this loophole of tax avoidance." (House Rep. No. 704, 73d Congress, 2d Session.)

The Reports of the Finance Committee of the Senate and of the subcommittee of the House Ways and Means Committee are to the same effect. (Senate Report No. 558, 73d Congress, 2d Session, p. 27; Hearings before Committee on Ways and Means, Revenue Revision 1934, p. 134.) See also remarks of Senator Harrison, Chairman of Senate Finance Committee; 78 Congressional Record, page 5847. *Cf.* Report on Stock Exchange Practices, Senate Committee on Banking and Currency. (Senate Report No. 1455, 73d Congress, 2d Session, pp. 321-327.)

fact that it took a statute to remove the exemption is clear proof that theretofore the test was whether the claimed loss was real rather than feigned. *Foster v. Commissioner,* 96 Fed. (2d) 130, *supra.*

Besides dealing a decisive blow to the merits of the government's petition, the 1934 amendment renders the question academic. A case involving the construction of a statute obsolete for five years hardly commends itself to a writ of certiorari. The government's argument that despite the 1934 amendment the case remains important is curiously inconsistent with its argument, in opposition to the taxpayer's petition, No. 147, that there is no occasion for reconsidering the *Slocum* decision because the new Federal Rules of Civil Procedure render the *Slocum* doctrine academic—this although the court below declined to apply the new Rules on the authority of the *Slocum* case. The 1934 amendment does put at rest the very question raised by the government's petition. The new Rules were intended to put the *Slocum* case at rest but will not so long as the decision below on this point is allowed to stand.[5]

The mere fact that the 1934 amendment may not settle the point involved in the *Griffiths* case, No. 49, this term, *supra,* is no reason for granting certiorari in the case at bar.

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[5] The government's attempt in No. 147 to justify the decision below on the ground that the trial was held before the effective date of the new Rules is entirely beside the point. The Court of Appeals expressly held that the new Rules were applicable to the case at bar, as an action pending (Cross-petition for Certiorari, No. 147, p. 3). The Collector's motion for amendment of the opinion was based entirely on the *Slocum* case (R. 771-4).

CONCLUSION.

The petition should be denied.

Dated, New York, N. Y., August 7, 1939.

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APPENDIX.

REVENUE ACT OF 1932, C. 209, 47 STAT. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *.

REVENUE ACT OF 1934, C. 277, 48 STAT. 680:

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * * *

(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph— (C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.